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Unlocking Stockholder Value with Spin-Offs

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Spin-offs and other business separation transactions have reemerged as a favored way for large, diversified companies to unlock stockholder value. This article provides an overview of the reasons for dividing a company, the varied structures used to effect a business separation, and the legal issues that executives and their advisors need to bear in mind.

1. Why a Business Separation?. There are many reasons for a company to pursue a business separation or "break-up" transaction. Business separations enable companies to tailor their strategic plans, business policies and capital allocation decisions to the unique needs of particular business lines. They can improve management focus and facilitate the alignment of management compensation packages with the strategic goals and performance metrics of the particular businesses. Business separations can also eliminate intra-company conflicts that prevent different business lines from pursuing agreements with each other's competitors. Further, separation transactions can free unique businesses to pursue their optimal capital structure and resource allocation, independent of considerations for the other businesses. They may also facilitate the sale of a single business or subset of businesses. Some break-ups are also motivated by the desire of management to rid itself of a business that has a high risk or low return profile relative to the company as a whole. Finally, separation transactions may also be used to defend against hostile takeovers, avoid burdensome regulations imposed on a company-wide basis, reduce liability insurance expenses, or avoid violating antitrust laws.

Many business separation transactions are ultimately driven by management's or activist stockholders' desire to improve share prices, independent of business performance considerations. The market may discount conglomerates as a result of, among other things, the difficulty in valuing several unrelated businesses comprising a single company. "Pure play" companies, by contrast, are generally easier for investors and analysts to understand and may command a relatively higher market value as a result.

2. Separation Transaction Forms. Business separations can be effected by any of several structures, including a spin-off, a subsidiary initial public offering (an "IPO"), or

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an M&A transaction. In the typical spin-off, the parent company distributes subsidiary stock to its stockholders in a tax-free, pro rata dividend. A spin-off does not, however, generate additional capital for the parent company or the subsidiary business. If the parent company or the spin company will need additional capital, the transaction planners will have to think about how they will address that need.

The parent company can also sell its interest in the subsidiary through an IPO. This form of break-up transaction allows the parent to accomplish many of the same objectives of the spin-off while raising additional capital. The sale of subsidiary stock, however, may be taxable to the parent company. Further, because the parent may continue to hold a stake in the spin company, the transaction may not eliminate conflicts among businesses or address antitrust concerns. The parent company may attempt to solve these problems by combining the subsidiary IPO with a spin-off in which all of the parent company's interest in the subsidiary business is disposed.

The parent company may also effect the business separation by sale in an M&A transaction. The parent may begin to explore the break-up by testing the waters in the M&A market. If an M&A transaction can be conducted at a sufficiently attractive price, the parent company may proceed. Otherwise, it might pursue a spin-off or IPO. Pursuit of a spin-off or IPO also has the effect of drawing potential buyers out. The parent company that initiates steps toward a spin-off or IPO may ultimately pursue an M&A transaction once a buyer emerges with an attractive offer. As with an IPO, an M&A transaction can provide additional capital to the parent. The sale of the business unit to a third party will, however, also be taxable to the parent in most cases. Further, a distribution of sale proceeds to parent company stockholders may be taxable.

3. Structuring the Transaction. Before a business separation transaction is complete, the parent company must ensure that the transaction will not leave either the parent or the subsidiary unable to conduct its business as an independent entity. Considerations may include: (1) the allocation of assets, (2) the allocation of liabilities, and (3) the division of employees among the parent and subsidiary. One approach to the allocation of assets and liabilities has been to prepare pro forma balance sheets for the parent and the subsidiary business, showing the anticipated financial position of the two entities on the effective date of separation. Transaction documents are then drafted to provide that the allocation of assets and liabilities will track the pro forma balance sheets. The transaction documents sometimes provide that payments and/or asset and liability transfers will be adjusted to the extent that audited balance sheets show the actual, post-separation financial positions of entities to differ from the pro forma balance

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sheets. The allocation of assets and liabilities may be set forth in a separation agreement or distribution agreement, depending upon the type of separation transaction. The transaction may include additional agreements that address taxes, shared intellectual property, employees and related benefits, as well as administrative support. When the parent and the spin company will continue to do business with each other, it may be necessary to draft an agreement describing the terms of their arrangement. Further, third-party consents to the reorganization and separation transactions, including governmental approvals, may also be required.

4. Other Legal Considerations.

a. Securities Laws. There are a host of considerations if the subsidiary business is going to be publicly traded after separation. For example, the subsidiary must have a charter, bylaws and authorized capital that are appropriate for a public company. In a spin-off transaction, the parent company must also determine whether the transaction should be registered under the Securities Act of 1933, as amended (the "Securities Act").[1] Staff Legal Bulletin No. 4 states that a spin-off does not need to be registered under the Securities Act if five conditions are satisfied: (1) there can be no consideration provided to the parent company for the subsidiary shares; (2) the spin-off must be pro rata to the parent stockholders; (3) the subsidiary stock must be registered under the Securities Exchange Act of 1934, as amended (the "Exchange Act"),[2] and adequate information about the spin-off and the subsidiary must be made public; (4) there must be a valid business purpose for the spin-off (this condition helps allay SEC concerns that the parent company's motive is to profit from creation of a public market for subsidiary stock); and (5) "restricted securities" that are spun-off must have been held by the parent company for at least two years.[3]

In the case of an unregistered spin-off, the "adequate information" requirement is generally satisfied by the subsidiary's filing of a Form 10 registration statement under the Exchange Act, which wraps around a Regulation 14C compliant information statement.[4] As a general matter, the Form 10 requires disclosure to the same extent that would be required for a company that undertakes an initial public offering. The Form 10 must be declared effective and the subsidiary's stock must be approved for listing on the Nasdaq or appropriate exchange prior to the effective date of the separation. Alternatively, "adequate information" about the subsidiary may be deemed

1 15 U.S.C. 77a et seq.
2 15 U.S.C. 78a et seq.
3 See SEC Legal Bulletin No. 4 (Sept. 16, 1997).
4 17 C.F.R. § 249.210 Form 10.

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to exist if the subsidiary has been subject to the Exchange Act reporting requirements for at least 90 days and is current in its reporting.[5] In this case, however, information about the transaction would still need to be provided. In either event, the subsidiary business will not be eligible to use Form S-3 for at least twelve months unless it was a reporting segment of the parent company. It will likely be eligible to use Form S-8 immediately, however.

b. Corporate Laws

i. Fiduciary Duty. The decision to pursue a business separation transaction is protected from challenge by the business judgment rule in most instances. The business judgment rule is predicated upon an assumption that directors of the parent company did not violate their fiduciary duties when approving the transaction.[6] If the business judgment rule is not available, the decision to pursue the transaction may be subject to an "entire fairness" standard of review.[7] Under the entire fairness standard, the directors must prove that the transaction is consistent with notions of fair dealing and fair price. The directors may be able to avoid the entire fairness doctrine, fiduciary duties notwithstanding, if the transaction is ratified by a vote of the stockholders.[8] It should be noted that directors owe no fiduciary duties to future stockholders of the subsidiary business when considering the transaction.[9]

There are two key elements to the fiduciary duty under Delaware law: (1) a duty of due care and (2) a duty of loyalty.[10]

1. Duty of Care. Directors must approve business separation transactions in light of all material information reasonably available.[11] Directors should also evaluate the risks and benefits associated with alternative strategies for accomplishing the parent company objectives.[12] Directors may base their ultimate decision upon reports and information provided by officers of the parent company and experts. However, directors should make reasonable inquiry into the quality and veracity of such information.[13]

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5 SEC Staff Legal Bulletin No. 4, 3 (Sept. 6, 1997).
6 See *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985).
7 See *Weinberger v. UOP, Inc.*, 457 A.2d 701, 710 (Del. 1983).
8 *In re Santa Fe Pacific Corp. Stockholders Litigation*, 669 A.2d 59, 68 (Del. 1995).
9 *Anadarko Petroleum Corp. v. Panhandle Eastern Corp.* 545 A.2d 1171 (Del. 1988).
10 See *Cede v. Technicolor, Inc.*, 634 A.2d 345, 367 (Del. 1993); *Polk v. Good*, 507 A.2d 531, 536 (Del. 1986); *Smith v. Van Gorkom*, supra note 6.
11 See *Aronson v. Lewis*, 473 A.2d 805, 811 (Del. 1984).
12 See *In re Fort Howard Corp. Stockholders Litigation*, C.A. No. 9991, slip op. at 3 (Del. Ch. Aug. 9, 1988).
13 See, e.g., Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 371 (Del. 1993); *Citron v. Fairchild Camera & Instrument Corp.*, 569 A.2d 53, 66 (Del. 1989).

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2. Duty of Loyalty. The duty of loyalty is most clearly implicated when there are conflicts of interest. For example, there might be conflicts if directors or officers of the parent company also serve as directors of the subsidiary. Further, the parent company may owe duties to minority stockholders or officers in the subsidiary, if the subsidiary is not wholly-owned.[14] The board of directors may be able to avoid certain duty of loyalty challenges if its decisions are approved by a special committee of disinterested directors.[15]

Fiduciary duties may become complicated when a spin-off transaction is used as a takeover defense or combined with a merger of the parent company. If an operating business is spun-off in response to a hostile takeover attempt, the directors' decision will be subject to review under the *Unocal* standard, rather than the traditional business judgment rule. The *Unocal* standard requires that (a) there must be a basis for determining that the spin-off defense serves a legitimate corporate purpose and (b) the spin-off must be reasonable in relation to the takeover threat.[16] The *Unocal* standard effectively requires the directors to explain how the spin-off furthers a broader company strategy and will result in greater long-term value to stockholders than what has been proposed in the hostile bid.[17]

When a spin-off is coupled with a merger that involves a change in control at the parent company, the directors' decision to approve the transaction must satisfy their *Revlon* duties. The *Revlon* duties require directors to seek the highest price for the company that is reasonably available under the circumstances.[18] The adequacy of the decision-making process and even the reasonableness of the decision itself will be subject to judicial review. The directors must be able to show that the spin-off was a reasonable means of maximizing stockholder value in connection with the merger.[19]

ii. Stockholder Votes. Business separation transactions do not generally require stockholder approval unless the business being separated comprises substantially all of the assets of the parent company. In most spin-offs, the subsidiary business is not as large as the remaining parent company. Further, Delaware practitioners generally agree that, irrespective of the size of the subsidiary, a spin-off transaction does not constitute

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14 See *Sinclair Oil Corp. v. Levien*, 280 A.2d 717 (Del. 1971); *Getty Oil v. Skelly Oil Co.*, 267 A.2d 883 (Del. 1970).
15 See *In re Formica Corp. Stockholders Litigation*, [1989 Transfer Binder] CCH Fed. Sec. L. Rep. ¶98,362 at p.92,392 (Del. Ch. Mar. 22, 1989); *Kahn v. Lynch Communication Systems*, 638 A.2d 1110, 1115-1117 (Del. 1994).
16 *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955 (Del. 1985).
17 *Grand Metro. PLC v. Pillsbury Co.*, 558 A.2d 1049 (Del. Ch. 1988).
18 *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986).
19 *Paramount Communications v. QVC Network*, 637 A.2d 34, 44 (Del. 1994).

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a sale, lease or exchange triggering a stockholder vote under Section 271 of the Delaware General Corporation Law.[20] Stockholder approval may be desirable nonetheless as a means of defending a legal challenge if there is any question about whether the directors of the parent company were able to satisfy their fiduciary duties. Stockholder approval may also be mandatory if the separation transaction is coupled with a merger of the parent company.

c. Fraudulent Conveyances. Business separations can be susceptible to challenge on the basis of federal and state fraudulent conveyance law.[21] The creditors of the parent company or the spun-off company may commence fraudulent conveyance litigation if they believe that the spin-off transaction left the parent or spin-off company under-capitalized, and increased the likelihood that debts would not be paid. The pre-spin reorganization may be deemed a fraudulent conveyance if the parent company or subsidiary receives less than fair value for transferred assets during the reorganization, and is either insolvent at the time of the spin-off or, as a result of the spin-off, becomes unable to pay its creditors.[22] The spin-off dividend itself may also be deemed a fraudulent conveyance if either the parent or the spin-off company are left unable to satisfy their obligations.

d. Tax Issues. Certain business separation transactions may qualify for tax-free treatment. Spin-offs generally qualify for tax-free treatment under Section 355 of the Internal Revenue Code of 1986, as amended (the "IRC"),[23] if: (1) the subsidiary business is controlled by the parent immediately before the distribution and only the subsidiary's securities are distributed (control is defined as owning at least 80% of the voting stock and at least 80% of the non-voting stock); (2) the transaction is not used as a means of distributing profits; (3) the parent company and the subsidiary have actively conducted a trade or business for at least five years and continue to do so immediately after the spin-off; (4) the parent company distributes an amount of stock in the subsidiary corporation constituting control[24]; (5) the spin-off has a business purpose[25]; (6) the parent company's stockholders, in the aggregate, continue to own stock in both companies after the spin-off[26]; and (7) both the parent and subsidiary continue at least

20 Del. Gen Corp. L. § 271.
21 See, e.g., Uniform Fraudulent Conveyance Act, 7A Unif. L. Ann. 6 (2001); Uniform Fraudulent Transfer Act, 7A Unif. L. Ann. 274 (1999); Bankruptcy Code §§ 544(b), 548, 598, 11 U.S.C. §§ 544(b), 548, 598.
22 In general, fraudulent conveyance statutes prohibit transfers that leave an unreasonably small amount of capital and transfers made by persons who know or believe that they will be unable to pay their debts after the transfer.
23 IRC § 355.
24 "Control" is defined in IRC § 368(c).
25 Treas. Reg. § 1.355-2(b).
26 Treas. Reg. § 1.355-2(c).

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one of their businesses or use a significant portion of their historic business assets following the spin-off.[27]

The rules requiring parent company control of the subsidiary at the time of the spin-off have implications for transactions where a subsidiary IPO is coupled with a spin-off. The 80% ownership threshold means that the parent company cannot use the IPO to sell more than 20% of the voting power in subsidiary stock. Parent companies have attempted to avoid this stricture by recapitalizing the subsidiary company with two classes of voting stock, and selling the bulk of the economic interests in connection with the IPO but retaining the class of shares with super-voting powers sufficient to meet the 80% test.

Spin-offs in connection with a merger of the parent company may not qualify for tax-free treatment. Under Section 355(e) of the IRC, a spin-off will be taxable to the parent company if it is part of a plan that enables persons other than the parent company stockholders to acquire a majority interest in either the parent company or the spun-off subsidiary.

5. Conclusion. Business separation transactions can unlock shareholder value, but they are complex and often fraught with difficult business and legal issues. Compounding the complexities is the fact that what makes the most business sense may not be legally advisable. And structures that are preferable from a liability standpoint may be economically impractical. The benefits and risks of the varied transactional structures must be weighed, and the business and legal considerations harmonized, so that stockholder value is both increased and protected.

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27 Treas. Reg. § 1.355-2(c)(2).

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